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In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 125

UNITED STATES OF AMERICA, PETITIONER

v.

WILLIAM L. RANDALL, TRUSTEE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The memorandum and order of the district court (A. 50–51) are not officially reported. The opinion of the court of appeals (A. 53–63) is reported at 419 F. 2d 1068.

JURISDICTION

The judgment of the court of appeals was entered on December 12, 1969 (A. 64). On March 4, 1970, Mr. Justice Marshall extended the time for filing a petition for a writ of certiorari to and including April 11, 1970 (A. 65). The petition was filed on April 9, 1970, and was granted on October 12, 1970 (A. 65). The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, under Section 7501(a) of the Internal Revenue Code of 1954, F.I.C.A. and income taxes withheld from salaries paid to employees by a debtor in possession during an arrangement under Chapter XI of the Bankruptcy Act constitute a trust fund that is not a part of the arrangement estate to be distributed to creditors in a subsequent liquidating bankruptcy proceeding.

STATUTES INVOLVED

The pertinent provisions of Section 64a of the Bankruptcy Act, as amended, 11 U.S.C. 104; 28 U.S.C. 960, and Section 7501(a) of the Internal Revenue Code of 1954 are set forth in the Appendix, *infra*, pp. 23–26.

STATEMENT

Halo Metal Products, Inc., filed a petition for an arrangement under Chapter XI of the Bankruptcy Act on August 18, 1967 (A. 47, 54). On August 24, 1967, the referee entered an order allowing the debtor to remain in possession and to carry on its business, subject to the arrangement court's supervision and control (A. 17–19, 47, 54). Among other things, the referee's order required the debtor in possession to file monthly reports, to keep separate books and records of its operations during the arrangement proceedings, to open three separate bank accounts for its general, payroll and tax indebtedness, and to make appropriate disbursements from these accounts (A. 17–18). The full amount of salaries and wages paid to employees was to be credited against the payroll account, and checks for wages and for the withheld

income and F.I.C.A. taxes were to be submitted to the referee for approval and then paid. The checks for the withheld taxes were to be paid into the tax account. Withdrawals from this account were to be allowed only for payment of withheld taxes and welfare benefits. The referee instructed the debtor to make returns called for by law (A. 18–19).

Halo failed to comply with these requirements. Although it withheld income and F.I.C.A. taxes from the wages of its employees, it failed to deposit these taxes in the special tax account[1] and did not pay them to the United States as required by the arrangement court's order (A. 47, 54).

Subsequently, Halo was adjudicated a bankrupt on November 22, 1967 (A. 36, 47, 54). The United States had previously filed a proof of claim in the Chapter XI proceeding for payment of $1,075.02 of F.I.C.A. and income taxes withheld by the debtor in possession during the arrangement on the ground that under Section 7501(a) of the Internal Revenue Code of 1954 this amount was a special trust fund in favor of the United States. Thereafter, on December 22, 1967, the United States filed a petition in the bankruptcy proceeding seeking to enforce the trust in its favor created under Section 7501(a) through payment of the amount of withheld taxes prior to payment of the costs and expenses of administration of

[1] The debtor indicated in some of the reports which he filed that he had deposited the withheld taxes into a "temporary Trust Account." A. 20, 23–24, 27–28, 32, 40. The referee found, however, that the debtor had failed to set aside these funds (A. 48).

the bankruptcy proceeding (A. 37–38, 47, 54). The referee denied the government's petition, on the ground that the withheld taxes were merely administrative expenses of the bankrupt estate, required to share in the first priority for such expenses under Section 64a of the Bankruptcy Act (A. 44, 46–49). The district court agreed with the referee that "all priorities in bankruptcy matters should be determined pursuant to § 64a of the Bankruptcy Act * * * and that the trust fund concept of § 7501(a) should not be interpreted to change the scheme of priorities in the Bankruptcy Act" (A. 50–51). The court of appeals affirmed (A. 53–63).

SUMMARY OF ARGUMENT

I

The Court of appeals characterized the issue in this case in terms of the relative priorities of various administrative expenses of the bankrupt estate. This misconstrued the nature of the government's claim with respect to withheld taxes—which is not that they are owed as administrative debts of the bankrupt estate, but, rather, that they are "owed" exclusively by the employees from whose wages they were withheld, and are merely held by the employer as the government's collecting agent. They are, therefore, not an asset of the bankrupt estate.

This principle is reflected in the entire statutory scheme governing the withholding of taxes, and especially in Section 7501(a) of the Internal Revenue Code of 1954, in which Congress specifically imposed on withheld taxes a trust in favor of the United States. Section 64a(1) of the Bankruptcy Act, which gives equal prior-

ity to all administrative expenses, does not affect the government's right to the proceeds of the Section 7501 trust in this case, because that provision governs the distribution only of funds which are assets of the bankrupt estate. *Nicholas* v. *United States,* 384 U.S. 678, in which the Court denied the government's claim for interest on withheld taxes, does not control the question of the disposition of the principal amount of the trust fund. The Court in *Nicholas* specifically reserved decision of the latter question.

II

The Section 7501 trust created in this case was not defeated by the failure of the debtor in possession to segregate the withheld taxes in a separate bank account, and the consequent inability of the government to trace the *res* of the trust. The general requirements of tracing do not always apply in the case of trusts which are constructively imposed by statute or by operation of common law, because it is anomalous to make the beneficiary of such a trust dependent upon the formal acts of an involuntary trustee.

It would be particularly undesirable to apply the requirement of tracing in the present case, because here the constructive trustee, the debtor in possession, was a court-appointed officer of the bankruptcy proceeding, and had been specifically ordered by the referee to segregate the withheld taxes and pay them when due. To require tracing here "would be condoning improper action by a trustee so long as he could successfully get away with it." *City of New York* v. *Rassner,* 127 F. 2d 703, 706 (C.A. 2).

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ARGUMENT

I. THE WITHHELD TAXES ARE SUBJECT TO A TRUST IN FAVOR OF THE UNITED STATES CREATED BY SECTION 7501(a), AND NEVER WERE PART OF THE ARRANGEMENT OR BANKRUPTCY ESTATE

Section 7501(a) of the Internal Revenue Code of 1954 (*infra*, p. 26) provides that federal taxes required by law to be withheld constitute "'a special fund in trust for the United States.'" In the present case, the courts below characterized the question presented as whether the trust imposed on withheld taxes by Section 7501(a) is superseded by the priority granted to all administrative expenses under Section 64a(1) of the Bankruptcy Act, *infra*, p. 23. In the view of the court of appeals, the determinative factor was that Congress, in enacting Section 64a(1),

> clearly rejected earlier priority schemes giving some administrative expenses higher priorities than others and provided that all such claims should share equally on a first priority basis. The statute gives no hint of any Congressional intent to continue the more favorable treatment of certain administrative expenses [A. 59-60].

As the court acknowledged, its decision is contrary to decisions of the courts of appeals for the Second, Sixth and Ninth Circuits. *City of New York* v. *Rassner*, 127 F. 2d 703 (C.A. 2); *In re Airline-Arista Printing Corp.*, 267 F. 2d 333 (C.A. 2), affirming *per curiam* 156 F. Supp. 403 (S.D.N.Y.); *Hercules Service Parts Corp.* v. *United States*, 202 F. 2d 938 (C.A.

6); *United States* v. *Sampsell*, 193 F. 2d 154 (C.A. 9).[2]

By treating the issue in this case as a matter of the relative priorities of various administrative expenses of the bankrupt estate, the court of appeals has, we submit, fundamentally misconstrued the character of the taxes which an employer withholds from the wages of his employees. These withheld taxes are not owed by the employer to the United States as a "debt," or, in the case of an insolvent employer, as an administrative expense of the arrangement or bankrupt estate. Rather, these funds are held by the employer as the government's collecting agent and are in no sense part of the bankrupt estate. Like the sales tax in *In re E. Goldberger, Inc.*, 32 F. Supp. 615, 616 (E.D.N.Y.):

> At no time did this sum become a part of the estate of the bankrupt for general distribution. This amount must be paid to the city of New York before the payment of the expenses of administration, not because of priority, but due to the fact that the debtor was only the trustee of the money collected * * *.

Indeed, the entire statutory scheme governing the withholding of taxes by employers establishes that the withheld tax is "owed" exclusively by the employee, and the employer is "merely the collection agent for its taxpayer employees." *Eighth Street Baptist*

[2] The decision below is in accord with that in *In re Green*, 264 F. Supp. 849 (D. Colo.). See, also, *In re Connecticut Motor Lines, Inc.*, 336 F. 2d 96 (C.A. 3), which applied similar reasoning in the context of a related issue (see footnote 7, *infra*). Cf. *United States* v. *Fogarty*, 164 F. 2d 26 (C.A. 8).

Church, Inc., v. *United States*, 26 A.F.T.R. 2d 5540, No. 476–69 C.A. 10, decided, September 23, 1970; *Jules Hairstylists of Maryland, Inc.*, v. *United States*, 268 F. Supp. 511 (Md.), affirmed per curiam, 389 F. 2d 389 (C.A. 4), certiorari denied, 391 U.S. 934. The taxes themselves, of course, are required to be withheld from the "wages" of the employees, which are defined as the gross amount paid to the employee, not the net amount after deduction of the withheld taxes. See Sections 3121(a), 3102(a), and 3401(a) and 3403 of the Internal Revenue Code of 1954.[3] Once the employee's wages have been paid, the deducted amount is considered paid to him at that time (Section 3123), and the employee's tax liability with respect to that amount is considered to have been discharged (Section 31). If the employer withholds and pays to the United States an excessive amount, the employee, not the employer, is entitled to claim a refund or credit. See Treasury Regulations on Employment Tax (1954 Code), §§ 31.6402(a)–2(a)(2) and 31.6402(a)–2(b).[4] If the employer fails to pay over a withheld tax, Section 6672 of the Internal Revenue Code charac-

[3] See, also, Section 3502, 1954 Internal Revenue Code, which provides that the employee's portion of F.I.C.A. taxes shall not be deductible by him in computing his taxable income.

[4] The same scheme applies to excise taxes. For example, although liability for payment of a manufacturer's excise tax is imposed upon the seller, the incidence of the tax falls upon the purchaser, and the latter has the right to recover any overpaid amount. See Section 4061 of the 1954 Code. The seller is not entitled to a refund or credit of taxes paid by him unless he can show that he, and not the purchaser, bore the economic incidence of the tax, or the purchaser consented in writing to allow the seller to recover any refund. See Section 6416 of the 1954 Code.

terizes his obligation to the government not as a tax liability, but as a "penalty equal to the total amount of the tax * * * not * * * paid over."

Recognizing that withheld taxes are held by the employer as a collecting agent for the benefit of the United States, Congress enacted special provisions by which the United States can collect these taxes. In addition to the usual debt collection remedies applicable to an ordinary tax obligation, Congress in Section 7501(a) imposed on withheld taxes a constructive trust, which subjects the withheld amount to collection through trust remedies.[5] That Section provides:

> Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

This provision originated as Section 607 of the Revenue Act of 1934, c. 277, 48 Stat. 680, which was applicable to the withholding or collection of excise taxes. The Senate Committee Report, in recommending enactment of this language (there denoted as Section 606), explained its purpose and effect as follows

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[5] See *In re Allied Electric Products, Inc.*, 194 F. Supp. 26, 30-31 (D. N.J.); see, also, *V Scott on Trusts* (3d ed.), Sec. 508.1; Bogert, *Trusts and Trustees* (2d ed.), Secs. 867, 921.

(S. Rep. No. 558, 73d Cong., 2d Sess., p. 53 (1939-1 Cum. Bull. (Part 2) 586, 626)):

> Existing law provides with respect to a number of taxes that the amount of the tax shall be collected or withheld from the person primarily liable by another person, who is required to return and pay to the Government the amount of the taxes so collected or withheld by him. This is true, for example, in the case of the taxes on admissions, checks, and telephone and telegraph services. Under existing law the liability of the person collecting and withholding the taxes to pay over the amount is merely a debt, and he cannot be treated as a trustee or proceeded against by distraint. Section 606 of the bill as reported impresses the amount of taxes withheld or collected with a trust and makes applicable for the enforcement of the Government's claim the administrative provisions for assessment and collection of taxes.[6]

The consequence of this statutory scheme in the instant case is that, when the debtor in possession paid the wages from which the taxes in question were deducted, the withheld funds were taken out of the arrangement estate and, by virtue of Section 7501(a)

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[6] The Conference Report confirmed this result as follows (H. Conference Rep. No. 1385, 73d Cong., 2d Sess., p. 32 (1939-1 Cum. Bull. (Part 2) 627, 639-640)):

> This amendment impresses taxes collected or withheld with a trust in favor of the United States and makes applicable for the enforcement of the Government's claim the administrative provisions applying to the assessment, collection, and payment of taxes. There is no comparable provision in the House bill. The House recedes with an amendment changing the section number.

deemed to be held as "a special fund in trust for the United States." The taxes could not be considered administrative expenses of the bankruptcy estate under Section 64a not only because, as taxes, they were owed only by the employees, but also because the withheld funds were not in any sense assets of the estate and, therefore, could not be used to discharge debt liabilities of the estate. This result is not unfair to respondent's unsecured creditors, whose priorities are established by Section 64a of the Bankruptcy Act, because these creditors should not have expected to receive payment from assets which did not belong to the bankrupt company and which the bankruptcy court had previously ordered to be paid over to the government. Indeed, it is hardly likely that Congress, when it chose to utilize employers as collection agents for the taxes of their employees, intended to bestow a windfall on the employers' creditors, at the government's expense.

In support of its holding, the court below cited the second sentence of Section 7501(a), which provides that the amount of the trust fund created by that Section "shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose." In the court's view, this provision "makes collection of the trust fund in bankruptcy situations subject to the usual bankruptcy rules * * *" (A. 58), and requires classification of the taxes withheld by the debtor in

possession as administrative expenses of the arrangement estate.[7]

It is difficult to understand how the court of appeals found such a design in Section 7501(a). The second sentence of that provision obviously should not be read in isolation from the first sentence's express imposition of a *trust* in favor of the United States. The brief committee report on the predecessor of Section 7501(a), quoted in its entirety above (*supra*, p. 10), clearly indicates that a trust was imposed on withheld taxes in order to *expand* the collection remedies available to the government with respect to these funds by providing the remedies applicable both to tax debts and to trusts. Indeed, the committee report indicates Congress' belief that, in the absence of Section 7501, the government could not even avail itself of the special tax collection remedies, such as distraint, against withholding employers, on the theory that employers are not considered taxpayers with respect to withheld taxes, so that the reference in Section 7501 to tax collection remedies was in itself an expansive provision. Even without this explicit legislative history, it would have been self-contradictory for Congress to have imposed a trust on withheld

[7] The court of appeals for the Third Circuit has also read the second sentence of Section 7501 in the manner suggested by the court below. *In re Connecticut Motor Lines, Inc.*, 336 F. 2d 96. The court there held that withheld taxes arising from wages earned prior to bankruptcy but paid during bankruptcy were fourth priority "taxes legally due and owing by the bankrupt" under Section 64a(4) of the Bankruptcy Act.

taxes and, at the same time, to have restricted the government exclusively to the rules of assessment, collection, and payment applicable to ordinary tax debts. And, of course, an interpretation of this provision which would deny the government trust benefits only in a bankruptcy situation would deprive the government of this statutory protection at precisely the time when it is most needed.

This Court's decision in *Nicholas* v. *United States*, 384 U.S. 678, does not preclude recognition of the Section 7501 trust imposed here. *Nicholas* also involved a Chapter XI arrangement which failed and was succeeded by a liquidating bankruptcy. During the Chapter XI proceeding the debtor in possession collected excise taxes from its customers and withheld taxes from its employees which it failed to place in a trust fund for the United States. When payment of the taxes became due the debtor had been adjudicated a bankrupt, and the bankruptcy trustee failed to pay the taxes. The United States filed a proof of claim in the ensuing bankruptcy proceeding for the principal of the taxes plus delinquency penalties for the trustee's failure to file timely returns, and also for interest on the unpaid taxes. The trustee conceded that the government was entitled to payment of the principal amount of the taxes as an administrative expense of the liquidating bankruptcy. The bankruptcy estate was sufficiently large so that it was immaterial whether the taxes were paid as administrative expenses under Section 64a(1) or as trust fund taxes, and this issue was never involved in that case. With respect to the payment of interest, the govern-

ment contended, *inter alia,* that the *Rassner* line of decisions (*supra,* pp. 6–7), which had been applied only to the unpaid principal amount of taxes, should be extended to interest on the taxes.

This Court, recognizing that interest payments may have to be made out of the assets of the estate, denied the government's claim for interest on the withheld taxes in *Nicholas* because of the "broad equitable principle," inapplicable to the principal amount of the taxes,

> that creditors should not be disadvantaged * * * by legal delays attributable solely to the time consuming procedures inherent in the administration of the bankruptcy laws [384 U.S. at 683].

With respect to the government's alternative argument that the interest should be considered part of the 7501(a) trust fund, the Court pointed out (384 U.S. at 691) that the second sentence of Section 7501(a)

> specifically provides that interest on such a trust fund is collectible in the same manner as the taxes from which the fund arose. Since we have already determined that no interest on any of the taxes here in question accrues beyond the period of the arrangement proceeding, no interest could accumulate on a trust fund composed of the withholding and cabaret taxes.

This holding with respect to interest does not deny the congressional purpose to expand the collection remedies available to the government with respect to the withheld taxes themselves. The Court specifically reserved (384 U.S. at 691) the significantly different question whether the Bankruptcy Act destroys

the trust explicitly imposed on the principal amount of the taxes by Section 7501—which in terms refers only to the taxes themselves.

Finally, the court of appeals, in support of its decision, referred to

> two parallel lines of statutory development, one continually reducing and limiting the priority to be accorded taxes and the other regularly according a more and more favorable priority to administrative expenses [A. 60].

The statutory developments invoked by the court have gradually reduced the priority formerly accorded to the government's claims for tax debts accruing prior to bankruptcy proceedings,[8] and have increased the priority of administrative expense claims and eliminated subpriorities within the category of administrative expenses. However, the cited statutes, the implications of which the court below has in some respects considerably exaggerated,[9] have no bearing

[8] See 3A Collier on *Bankruptcy*, pp. 2046–2048, 2155–2156.

[9] The opinion states, for example, that the amendment to Section 64a(1) contained in the Act of July 7, 1952, 66 Stat. 420, Sec. 19(a), "clearly illustrates Congressional reasoning in preferring administrative expenses to all others." A. 62–63. This amendment changed the existing rule that where a bankruptcy follows a debtor relief proceeding which has failed, and the estate available for distribution after liquidation in the ensuing bankruptcy is not sufficient to pay the administration costs of both proceedings, the arrangement and bankruptcy costs share pro rata in the estate's assets. Under the 1952 amendment, those costs necessary to liquidate and close the estate prevail over administrative expenses during the prior arrangement period. See S. Rep. No. 1395, 82d Cong., 2d Sess., p. 4. As the district court pointed out in *In re Airline-Arista Printing Corp.*, 156 F. Supp. 403, 406 (S.D. N.Y.),

> In the Rassner case the court recognized that "Of course, an overriding policy of the Bankruptcy Act could prevent

on the instant case, because the government is not seeking here to enforce payment of its claim out of the bankrupt estate, either as a claimant for pre-bankruptcy taxes under Section 64a(4) or as an administrative expense claimant under Section 64a (1). Instead, the government is merely seeking to enforce its right to the proceeds of a statutory trust imposed on funds which are not part of the bankruptcy estate, and the disposition of which is in no way affected by the cited provisions.[10] The court's

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preferred satisfaction of even trust claims." The question here is whether the 1952 amendment either by express language subordinated such a claim as this to bankruptcy administration expenses, or enunciated such an "overriding policy." I do not believe it did either.

There is nothing in the language of the 1952 amendment which expressly changes the rule laid down in the Rassner, Hercules Service and Sampsel cases. The amendment deals with the respective priorities between costs and expenses of administration incurred in ensuing bankruptcy and in proceedings superseded thereby. It does not attempt to negative any priority granted by statute or decision to a trust *res* in the coming into the hands of a debtor in possession in a superseded proceeding.

[10] Indeed, in at least one instance, the legislation cited by the court of appeals supports the government's theory in this case. The amendments to Sections 17a(1) and 64a(4) contained in the Act of July 5, 1966, P.L. 89–496, 80 Stat. 270, discharged claims for taxes which had become due and owing more than three years prior to bankruptcy, with certain enumerated exceptions, and retained a priority only for those tax claims which were not thereby discharged. One of the exceptions to discharge covers taxes "collected or withheld from others * * * but not paid over." The inclusion of a special exception for taxes withheld more than three years prior to bankruptcy shows Congress did not intend to impose the restrictions applicable to ordinary tax debts on the collection of these special funds in trust. The court below dismissed the relevance of this exception to the instant

reliance on these provisions is a further indication that it fundamentally misconstrued the nature of the government's claim.

II. THE FAILURE OF THE DEBTOR IN POSSESSION TO SEGREGATE THE WITHHELD TAXES DID NOT DEFEAT THE TRUST CREATED BY SECTION 7501(a)

The court of appeals did not specifically address itself to the respondent's argument below that the trust imposed on the withheld taxes was defeated by the failure of the debtor in possession to comply with the referee's order requiring the debtor to place the withheld taxes in a separate account, and, consequently, by the government's inability to trace the *res* of

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case with the rather confusing explanation that the government seeks to recover withheld taxes here "not as taxes but as an administrative expense * * *." R. 61, fn. 8. On the contrary, the government seeks to recover these funds neither as tax debts nor as administrative expenses, but as funds held in trust.

It is of relevance here that this legislation as originally drafted in 1957 (H.R. 2171, 85th Cong., 1st Sess.) contained only two exceptions to discharge, *viz.*, where a taxpayer failed to file a return, and where he filed a false or fraudulent return. The Treasury opposed this proposal and, among other things, requested that a specific exception to discharge be included for "liabilities resulting not from the bankrupt's failure to pay his own taxes but from his failure to keep intact money which he had obtained from others as a trustee for the Government" (H. Rep. No. 2535, 85th Cong., 2d Sess., p. 6). Although other exceptions to discharge were included in later bills, the House Judiciary Committee did not include any specific exception for taxes collected or withheld from others on the ground that such an exception was unnecessary, presumably because it believed that the trust imposed on these taxes precluded their discharge (see H. Rep. No. 735, 86th Cong., 1st Sess., p. 5). Following further requests by the Treasury in 1961 (H. Rep. No. 372, 88th Cong., 1st Sess., p. 6; S. Rep. No. 1134, 88th Cong., 2d Sess., pp. 7, 9), the House Judiciary Committee acceded to the Treasury's request and added this exception to Section 17a(1) by H.R. 3438, 88th Cong., 1st Sess., Sec. 2. This amendment was later enacted by the Act of July 5, 1966, P.L. 89-496, 80 Stat. 270, Sec. 2.

the trust. Indeed, the court's decision appears to be based on the broad rationale that a Section 7501 trust should not be recognized in a bankruptcy situation regardless of whether the *res* of that trust can be traced.

In any event, we submit that a Section 7501 trust, such as that created in this case, is not destroyed by the mingling of the trust fund with the assets of the arrangement estate. To hold otherwise would, as shown above, throw into the bankrupt estate funds which under the withholding provisions and Section 7501 were taken out of the estate at the time that the wages in question were paid to the debtor's employees. The requirement for tracing in the ordinary trust situation is intended, among other things, to prevent other creditors from being unfairly harmed. See 4A *Collier on Bankruptcy,* par. 70.25.[2] It is difficult to see how creditors can be unfairly harmed by not receiving repayment from funds which were not an asset of the estate to begin with.

Furthermore, the courts and the leading commentators agree that the general requirement of tracing the *res* should not always apply in the case of trusts which are constructively imposed by statute or by operation of common law. See, *e.g., In re Grigsby-Grunow,* 80 F. 2d 478 (C.A. 7); V Scott on *Trusts,* Sec. 521; Bogert, *Trusts and Trustees,* Sec. 921; cf. *Adams* v. *Champion,* 294 U.S. 231, 238. The rationale of these authorities is that it is anomolous to make the beneficiary of such a trust dependent upon the formal acts of a trustee, such as the debtor in possession in the instant case, whose role as trustee is imposed

upon him by operation of law rather than by mutual agreement of the trustee and the creator of the trust.

The considerations in favor of easing the requirement of tracing are particularly strong in a case such as this, in which the constructive trustee is a court-appointed officer in an equity proceeding, for to require tracing in such a case would allow the misconduct of a court-appointed officer to defeat the beneficiary's rights to the trust fund. For this reason, Professor Scott, after examining the various rules as to when tracing should be required, concludes that the equitable rule is that

> Where the funds are received by a public officer, such as a receiver or trustee in bankruptcy, the owner of the funds is entitled to priority with respect to the funds so received without further tracing [*Scott on Trusts,* Sec. 521].

In support of this rule, Professor Scott cites the *Rassner* and *Hercules* decisions, *supra,* in which the courts focused on the importance of requiring that court-appointed officers perform their obligations. As Judge Clark explained for the court in *Rassner,* 127 F. 2d at 706,

> If the debtor in possession failed to segregate the taxes collected from vendees, it did so under the control of the court. * * * If we hold that the city must now trace the funds, we state in effect that any beneficiary of a trust which is handled by an officer of a bankruptcy court must always protect himself by petitioning in advance for proper administration of the trust.

> Thus stated, it can be seen that we would be condoning improper action by a trustee so long as he could successfully get away with it. As a court of equity, a bankruptcy court can hardly proceed on this assumption. It is the duty of the bankruptcy court in distributing an estate to do so equitably.[11]

In the present case the referee, pursuant to Halo's petition for an arrangement under Chapter XI of the Bankruptcy Act, allowed Halo to remain in possession of its business during the arrangement and thus appointed Halo an officer of the court for the duration of the arrangement. The referee, in accord with 28 U.S.C. 960, authorized the payment of wages to Halo's employees and specificially ordered the debtor to place the withheld taxes in a special fund, and to make timely payment of those taxes.[12] When the Chapter XI arrange-

[11] Judge Clark also pointed out (127 F. 2d at 706):

> The city could hardly seek fine or imprisonment of debtor or its officers for failure to segregate funds—assuming the penal provisions, Administrative Code, c. 41, Tit. N, § 41-17.0, as amended by Local Laws 1940, p. 362, go that far—because the status of the debtor as under court control would be a defense. The most that the city could seek would be a court order directing the debtor in possession to keep sales tax receipts separate from the ordinary transactions of the business, in other words, to obey the sales tax law.

[12] 28 U.S.C. 960 (App. *infra*, p. 25) provides that "[a]ny officers and agents conducting any business under authority of a United States court shall be subject to all Federal, State and local taxes applicable to such business to the same extent as if it were conducted by an individual or corporation."

ment was superseded by the liquidating bankruptcy, and the debtor in possession was displaced by the respondent bankruptcy trustee, the trustee inherited all the obligations of the debtor in possession, including the obligation to pay over to the United States the funds held in the Section 7501 trust. See *In re Wil-Low Cafeterias, Inc.*, 111 F. 2d 83 (C.A. 2); 8 *Collier on Bankruptcy*, par. 6.32.[13] This Court should not allow the respondent trustee to invoke the misconduct of his predecessor in order to defeat the trust to which the United States is legally entitled.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed, and the case

[13] Respondents have not disputed that the debtor in possession was an officer of the court, and that respondent, as the debtor's successor, inherited his obligations. Section 302 of the Bankruptcy Act, as amended (11 U.S.C. 702), provides that "the date of adjudication shall be taken to be the date of the filing of the petition [for arrangement] under section 321 or 322." Section 378(a) (11 U.S.C. 778) provides that a bankruptcy proceeding which follows a Chapter XI proceeding "shall be conducted, so far as possible, in the same manner and with like effect as if a voluntary petition for adjudication in bankruptcy had been filed and a decree of adjudication had been entered on the day when the petition under this chapter [XI] was filed." Section 342 (11 U.S.C. 742) gives a debtor in possession "all the powers of a trustee appointed under this act, subject, however, at all times to the control of the court"; and under Section 343 (11 U.S.C. 743), "The receiver or trustee, or the debtor in possession, shall have the power, upon authorization by and subject to the control of the court, to operate the business and manage the property of the debtor." See *Reading Co.* v. *Brown*, 391 U.S. 471.

should be remanded for appropriate enforcement of the trust in favor of the United States.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.
JOHNNIE M. WALTERS,
Assistant Attorney General.
RICHARD B. STONE,
Assistant to the Solicitor General.
CROMBIE J. D. GARRETT,
KARL SCHMEIDLER,
Attorneys.

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APPENDIX

Bankruptcy Act, c. 541, 30 Stat. 544:

Sec. 64 [as amended by Sec. 1, Act of November 28, 1967, P.L. 90–157, 81 Stat. 511] DEBTS WHICH HAVE PRIORITY.—a. The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be (1) the costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition; the fees for the referees' salary and expense fund; the filing fees paid by creditors in involuntary cases or by persons other than the bankrupts in voluntary cases; where property of the bankrupt, transferred or concealed by him either before or after the filing of the petition, is recovered for the benefit of the estate of the bankrupt by the efforts and at the cost and expense of one or more creditors, the reasonable costs and expenses of such recovery; the trustee's expenses in opposing the bankrupt's discharge or in connection with the criminal prosecution of an offense punishable under chapter 9 of title 18 of the United States Code, or an offense concerning the business or property of the bankrupt punishable under other laws, Federal or State; the fees and mileage payable to witnesses as now or hereafter provided by the laws of the United States, and one reasonable attorney's fee, for the professional services actually rendered, irrespective of the number of attorneys employed, to the bankrupt in voluntary and involuntary cases, and to the petitioning creditors in involuntary cases,

and if the court adjudges the debtor bankrupt over the debtor's objection or pursuant to a voluntary petition filed by the debtor during the pendency of an involuntary proceeding, for the reasonable costs and expenses incurred, or the reasonable disbursements made, by them, including but not limited to compensation of accountants and appraisers employed by them, in such amount as the court may allow. Where an order is entered in a proceeding under any chapter of this Act directing that bankruptcy be proceeded with, the costs and expenses of administration incurred in the ensuing bankruptcy proceeding, including expenses necessarily incurred by a debtor in possession, receiver, or trustee in preparing the schedule and statement required to be filed by section 238, 378, or 483, shall have priority in advance of payment of the unpaid costs and expenses of administration, including the allowances provided for in such chapter, incurred in the superseded proceeding and in the suspended bankruptcy proceeding, if any; (2) wages and commissions, not to exceed $600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding, due to workmen, servants, clerks, or traveling, or city salesmen on salary or commission basis, whole or part time, whether or not selling exclusively for the bankrupt; and for the purposes of this clause, the term 'traveling or city salesman' shall include all such salesmen, whether or not they are independent contractors selling the products or services of the bankrupt on a commission basis, with or without a drawing account or formal contract; (3) where the confirmation of an arrangement or wage earner plan or the bankrupt's discharge has been refused, revoked, or set aside upon the objection and through the efforts and at the cost and expense of one or more creditors, or, where through the efforts

and at the cost and expense of one or more creditors, evidence shall have been adduced resulting in the conviction of any person of an offense under chapter 9 of title 18 of the United States Code, the reasonable costs and expenses of such creditors in obtaining such refusal, revocation, or setting aside, or in adducing such evidence; (4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy: *Provided, however,* That no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority: *And provided further,* That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court; and (5) debts other than for taxes owing to any person, including the United States, who by the laws of the United States is entitled to priority, and rent owing to a landlord who is entitled to priority by applicable State law or who is entitled to priority by paragraph (2) of subdivision c of section 67 of this Act: *Provided, however,* That such priority for rent to a landlord shall be restricted to the rent which is legally due and owing for the actual use and occupancy of the premises affected, and which accrued within three months before the date of bankruptcy."

(11 U.S.C. 104)

28 U.S.C.:

SEC. 960. *Tax liability.*

Any officers and agents conducting any business under authority of a United States court shall be subject to all Federal, State and local taxes applicable to such business to the same extent as if it were conducted by an individual or corporation.

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 7501. LIABILITY FOR TAXES WITHHELD OR COLLECTED.

(a) *General Rule.*—Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

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